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One year on – new BEPS disclosure requirements and a reflection on the key challenges of New Zealand's international tax changes

It has now been just over a year since the Government revamped New Zealand's international tax regime. We've helped lots of our clients respond to the new rules. Our previous Tax Tips provides technical details of the law changes. We've also had ongoing dialogue with Inland Revenue as we've worked through the practical application of the rules. In this Tax Tips, we share our key observations from our experience to date.

The law changes are now in effect for everyone, with the first wave of taxpayers preparing their income tax returns reflecting these challenging new rules, along with preparing new, compulsory disclosures confirmed by Inland Revenue this week.

New compulsory disclosure requirements – the BEPS disclosure form

To support the new rules, including the expanded information collection powers applying to large multinational groups, Inland Revenue will be introducing a new "BEPS disclosure form" (to be available in MyIR), and has released supporting guidance here.

We expect that the information disclosed will be used to report back to the Government on the effectiveness of the new rules, as well as being an investigative tool for both risk reviews and audits. We are expecting Inland Revenue to provide us with more detail in coming weeks about its compliance focus in this area and how the information collated will fit within that focus.

While the guidance has been published, the form has not yet been finalised. Our expectation at this stage is that taxpayers will be required to disclose:

- restricted transfer pricing information including where existing arrangements have been modified in contemplation of the new rules.
- hybrid instrument and entity information, including full details of any hybrid arrangements such as counterparty information and details of deductions subject to the regime.
- thin capitalisation information including the group's thin capitalisation ratio, asset values, and liability values. New Zealand groups with a thin capitalisation ratio less than 40% will not be required to complete this section.

The level of detail expected in the disclosure is significant. Many businesses that have already assessed the impact of the new rules will need to do more work to be able to complete the disclosures. Businesses that have not yet considered the impact of the changes need to do so now in the light of the pending disclosure requirements. In anticipation of this, we discuss the key areas of impact and challenge that we have identified in assisting taxpayers with interpreting and applying these rules.

The rules have continued to develop following enactment, highlighting their complexity

The rules are complex, and continue to be coloured and developed post enactment with the release of detailed guidance and remedial changes to reflect challenges in the practical application of the rules. We have been in continual dialogue with Inland Revenue during this time, and the opportunity to discuss the specific issues we identify with Inland Revenue as and when they arise has been invaluable.

Despite some improvements in design and drafting in various areas through the consultation process, errors have been picked up as businesses have begun to navigate the rules in practice. This highlights not only the complexity of the rules, but also the fact that insufficient time was allowed for testing to ensure the rules were correct, workable, and only captured intended arrangements from the date of enactment.

We see a continuing need for remedial changes, and we are working with Inland Revenue to identify these including bringing to Inland Revenue's attention the inherent complexities businesses have struggled to come to grips with.

In our experience, cross-border related-party debt, transparent entities, and the management and control of businesses have been the greatest focus areas for businesses.

Cross-border related-party debt

Interest deductions claimed on cross-border related-party debt are a key focus of the new rules. The combination of the restricted transfer pricing rules, thin capitalisation, and the hybrid regime affects interest expenditure deductible for tax purposes.

The interaction of the three different regimes is proving challenging. Overall, businesses are commonly experiencing significantly reduced deductions for interest. The allowable interest rate is generally lower, increases in thin capitalisation ratios of 10% to 15% are common, and all or some portion of deductions may be denied under the hybrid rules. On top of this, withholding tax costs have increased as a result of earlier reforms to the NRWT rules, with the first potential payment date under those new rules being 20 June 2019.

Many businesses tackled the new rules before they took effect. Some have accepted the deduction disallowances, and others have refinanced or renegotiated loan terms to align commercial and tax outcomes. Given the significant additional tax cost being faced by businesses, engagement at board and senior management levels has been required, with key focus areas including:

- stakeholder interests.
- commerciality of a new structure.
- effect of double taxation (where a higher interest rate is recognised in foreign jurisdictions).
- non-resident withholding tax inefficiencies (where interest paid is not fully deductible for tax purposes).
- base price adjustments under the financial arrangement rules.
- IFRS 9 accounting implications.

Many businesses are reviewing interest deductibility on a retrospective basis, which we have seen give rise to inefficient outcomes in some cases.

Restricted transfer pricing

In our experience, the restricted transfer pricing rules have had the greatest impact. The rules impose significant restrictions on the pricing of inbound cross-border related debt exceeding NZD $10 million, moving away from a typical arm's length approach to a unilateral set of prescribed rules and criteria.

Reduced interest deductions due to the restricted transfer pricing rules are not solely a reflection of complex funding arrangements with "exotic" terms and conditions. Plain vanilla funding arrangements are also affected because:

- a borrower with a leverage ratio exceeding 40% is now generally required to set the interest rate by reference to the highest credit rating in the group (rather than by its own credit rating, which would typically be lower).
- subordination can no longer be reflected in interest rate pricing, despite third party funding arrangements documenting subordination as a legal requirement.

We understand that Inland Revenue expected the application of the restricted transfer pricing rules to result in taxpayers with plain vanilla funding structures having a deductible interest expense comparable to that allowed under normal arm's length principles in most circumstances. This has not been the outcome, and we encourage Inland Revenue to address this with remedial legislative change.

A key difficulty with the rules is that most groups/borrowers do not have a formal credit rating. This is not an issue for groups with significant third party debt due to concessions available. However, other groups have had to undertake a comprehensive credit scoring exercise, which requires access to data at a group level. The requirement to also cross-check this against the stand-alone credit rating of the New Zealand borrower is burdensome.

Other challenges we have observed businesses encountering with the rules include:

- determining which credit rating approach is correct.
- subjectivity in assigning a theoretical credit rating to a company that does not have one.
- complexity in applying the concessions for "exotic terms" also present in third party debt.

It is vital that businesses subject to the new restricted transfer pricing rules, hybrid regime, and thin capitalisation calculations review the pricing and structure of their cross-border related-party debt arrangements in detail. It is expected that disclosure of positions under the rules will be required in the BEPS disclosure form.

Transparent entities and groups

Many multinational groups, managed funds, and private equity funds have entities in their group structure that are treated as transparent in one jurisdiction but opaque in another, which can give rise to asymmetric tax treatment of transactions. The hybrid rules target these types of outcomes.

We have encountered a number of challenging scenarios where the legislation is unclear or does not align with the policy intent. We have had the benefit of regular discussions on the difficulties of interpreting and applying the rules in client situations with Inland Revenue officials. The outcomes in some situations seem contrary to the policy intent, and engagement with Policy officials has been very useful for both our clients and Inland Revenue.

In cases where an asymmetric tax outcome is obvious, affected groups have actively considered changes to group structures or business operations to mitigate the effect of the hybrid rules. However, where the application of the rules is unexpected (as asymmetric tax outcomes have arisen unintentionally or are not considered to fall within the policy intent of the rules), groups have been slower to engage.

In our experience, the key challenges businesses are facing in applying the hybrid legislation include:

- understanding and applying the complex legislative provisions – this is particularly difficult where scenarios do not fit squarely within the published or “common” examples.
- obtaining the required information from within the global group – this is particularly difficult for entities that are not in normal group corporate structures such as widely-held investment funds or partnerships.

In many cases, the end result of applying the rules is that potential denial of deductions is effectively reversed. However, even in these situations, calculations and values are expected to need to be disclosed in the BEPS disclosure form. Businesses are likely to be faced with the compliance burden of undertaking a detailed quantitative analysis.

The hybrid rules are far reaching and it is critical that businesses carefully consider their application, even where the relevance of the rules may not be immediately obvious.

NZ companies with non-NZ directors and/or management teams

We commonly see New Zealand entities with Australian-based directors and/or management teams – with matters relating to both the Australian and New Zealand businesses often attended to during the same management meetings in Australia. We also see Australian entities with New Zealand-based directors and/or management teams. Companies adopting these practices are now at greater risk of being treated as dual tax residents, due to a combination of changes to the New Zealand/Australia double tax treaty and a change in approach to corporate tax residency from the Australian Tax Office (ATO).

Dual resident entities are at risk of forfeiting treaty benefits and potentially being denied deductions under the anti-hybrid rules, along with facing other potentially adverse tax consequences in both New Zealand and Australia. Treaty protection is no longer automatic (even where a company is tie-broken to New Zealand) and, in many cases, treaty protection will require an application to the Inland Revenue and ATO for a residency determination.

Dual residency is also subject to significant scrutiny and change in other jurisdictions (e.g. the UK, Singapore).

We have seen a number of proactive businesses relooking at governance matters to ensure they are not dual resident. We have provided assistance with the review of governance structures and the preparation of governance protocols, and we have helped to formalise policies to ensure that New Zealand businesses remain solely New Zealand tax resident.

With the introduction of the BEPS disclosure form, businesses will need to focus on dual residency in response to specific questions related to the anti-hybrid rules and dual resident entities.

Let's talk

The cumulative effect of the international tax changes has been significant in many cases. With the introduction of compulsory disclosure requirements, New Zealand's international tax regime must be considered on a timely basis. In our experience, obtaining the required information from overseas parties is often burdensome, and businesses should ensure that they allow for sufficient lead time to assess their operations.

Monitoring the BEPS measures enacted last year is a key item on the Government's tax agenda. Further, we understand Inland Revenue has significantly increased its transfer pricing staff capacity. To us, this indicates that Inland Revenue will have a greater focus on compliance with the international tax regime in the future.

If you haven't yet considered how these rules will affect you, come and talk to us! Our PwC experts in these areas are keen to engage and assist you in applying the new international tax rules.

Business premises exclusion: Inland Revenue guidance

Inland Revenue recently issued finalised guidance on the business premises exclusion that applies in relation to the land-taxing provisions.

The guidance considers the application of the business premises exemption to several land-taxing provisions of the Income Tax Act 2007, including sections CB 9 to 11. Generally, these sections will apply and tax the gains on the disposal of land where:

- the landowner or an associated person carries on a business of developing or dealing in land, or a building business, even where the land was not acquired for the purposes of that business; and
- the land is sold within 10 years of acquisition (or within 10 years of making improvements on the land, in the case of a building business).

The business premises exclusion (section CB 19) prevents the land-tax provisions from applying i.e. to the extent the exclusion applies, any gain is not taxable. This exclusion is of particular importance for businesses that are associated with a developer, land dealer, or builder.

The initial draft of the guidance indicated that bare land could not be treated as business premises. Rather, "business premises" required there to be some building on the land. The draft also suggested that, while the term "business premises" could encompass bare land around a building that was reserved for the use of the relevant business, this bare land had to be physically connected to the business premises to benefit from the exclusion. In our view, both of the propositions were not appropriate.

Specifically, in our view, business premises should benefit from the exclusion, even if the land has no building on it. A simple example is a quarry where there may be significant business operations on the land without the presence of any buildings. In this case, the business premises exclusion should apply and a quarry sold within 10 years of acquisition should not be subject to tax by virtue of the land owner being associated with a developer or land dealer.

Similarly, we disagreed that the exclusion should only apply to bare land reserved for business use that is physically connected to or adjoining the business premises. For example, on the approach of Inland Revenue's initial draft, if a carpark for business premises was not immediately connected to the business premises, it would not have benefited from the exclusion. In our view, there are no policy grounds to justify this interpretation.

We were pleased to see that Inland Revenue took on-board many of our comments and other public submissions on the various iterations of the draft guidance, including accepting the possibility that bare land could constitute business premises and that land reserved with business premises would not need to be connected to those premises.

However, we are disappointed that Inland Revenue did not address other concerns we had raised in the final guidance. One such example was clarifying whether the scope of the business premises exclusion includes situations where the business premises are leased to and occupied by a company in the same corporate group as the landowner and it is this other group company that carries on the relevant business. It is not uncommon in a group structure to have a property holding and business operations administered through separate group entities.

Another area where further clarity is required is whether farms would be constituted as business premises. We also commented that the term "occupy" should not require exclusive possession and that leased property should be able to constitute business premises in circumstances where the lessor maintains some physical presence on the land in the course of carrying on its business.

The application of the business premises exclusion can still be tricky in some circumstances. Please contact your usual PwC adviser if this is relevant to your business.

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